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MAR 10 1993

FEDERAL COMMUNICATIONS COMMISSION
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March 9, 1993

VIA FEDERAL EXPRESS

Donna R. Searcy
Secretary
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

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FCC - MAIL ROOM

Re: In the Matter of Simplification of the Depreciation Prescription Process, CC Docket No. 92-296

Dear Ms. Searcy:

Please find enclosed for filing an original plus eleven copies of the COMMENTS OF CALIFORNIA in the above-referenced docket.

Also enclosed is an additional copy of this document. Please file-stamp this copy and return it to me in the enclosed, self-addressed, postage pre-paid envelope.

Very truly yours,

Ellen S. LeVine

Ellen S. LeVine
Attorney for California

ESL:nas

Enclosures (13)

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	CC Docket No. 92-296
Simplification of the Depreciation Prescription Process	)	
	)	

COMMENTS OF CALIFORNIA

The People of the State of California and the Public Utilities Commission of the State of California ("CPUC") respectfully submit these comments in response to the Notice of Proposed Rulemaking ("NPRM") adopted by the Federal Communications Commission ("FCC") on December 10, 1992 in CC Docket No. 92-296. In its NPRM, the FCC sets out four options for simplifying the depreciation process. As discussed below, the CPUC favors the basic factors range option as the most appropriate.

I. INTRODUCTION

The CPUC appreciates the opportunity to offer comments in this very important and timely rulemaking. As state regulators responsible for reviewing utility depreciation rate studies, and ensuring that depreciation expenses reflect the actual rate of plant retirement, the CPUC supports the FCC's intention to simplify the depreciation prescription process. The CPUC has, over the years, regularly participated in three-way meetings with

FCC, and believe that the cooperative effort has been of mutual benefit.

Among the reasons for simplifying the depreciation process is to reduce costs. The CPUC, however, is skeptical that any simplification will substantially reduce represcription costs, since the CPUC believes that a large percentage of these costs results from maintaining accounting and property records necessary for income tax and valuation of the plant for property tax, etc. We also point out that voluminous study support submitted in connection with represcription is not required by the FCC or the states, but is offered voluntarily by the companies. Finally we note that any simplification adopted by the FCC will not significantly reduce depreciation study expenses for telephone companies within California's jurisdiction as we require a formal application every year to examine depreciation rates. We believe that depreciation rates should be examined annually to ensure their continued reasonableness under incentive regulation.

Nevertheless, the CPUC believes that there is room for streamlining the current process which has become complex over the years. Like other regulations in the rapidly enhancing technological and competitive climate facing the telecommunications industry we agree that depreciation simplification is necessary.

II. BASIC FACTORS RANGE OPTION

Of the four simplification options presented in the NPRM, the basic factors range option accurately reflects the actual rate of plant retirement and is the most acceptable. This option would allow carriers to select the future net salvage, projection life and survivor curve for each applicable account from within an established range.

As suggested in the NPRM, initial basic factor ranges could be developed from a statistical analysis of the basic factors underlying currently prescribed rates. We suggest that, should this option be adopted, the width of the range be determined simply by using the actual range of factors underlying the currently prescribed rates. For those carriers whose basic factors underlying their currently prescribed rates do not fall within the established ranges, they should be allowed to move into the established ranges without a phase-in period. In addition, two sets of ranges should be established, one each for the LECs and IXCs reflecting the equipment and usage.

In addition, basic factor ranges should be utilized initially only for the accounts which are not impacted by the rapid technological and competitive changes, such as the General Support Assets accounts, poles, aerial wire, conduit, etc. More resources should be dedicated to studying, analyzing and evaluating the switching and copper cable accounts that are more volatile and more impacted by the deployment of new digital and optical technology.

We suggest that under this option, a review and update of the ranges using industry-wide information be made every three years. It is imperative that carriers continue to maintain continuing property records and mortality data in order to provide analyses for use in developing and updating the basic factor ranges.

If adopted, the basic factors range option should not be mandatory. Once the initial selection has been made, carriers should not be allowed to change the selection option. Under this option, stockholders rather than ratepayers should be responsible for any depreciation reserve problems and current amortizations of reserve imbalances should be discontinued.

Two related issues regarding this simplification option on which the NPRM seeks comment are price cap treatment and continued use of the equal life group procedure ("ELG"). We believe that allowing the carriers to use the equal life group procedure will defeat the purpose of simplification. In addition, the accuracy of curve shapes under this option will make the use of ELG meaningless and should be discontinued.

III. DEPRECIATION RATE RANGE OPTION

Under this simplification option, a range of depreciation rates would be established for each applicable account rather than a range of lives, net salvages and survivor curves. As life and salvage factors would be ignored under this option, the concept of depreciation to match expense with capital consumption will be sacrificed for simplification. Also, this option uses industry average reserve, not the reserve position of the individual carrier which could be quite different. For these reasons, this option is not meaningful and should be considered less viable.

Under this option statistical analysis of industry-wide currently prescribed rates, which would include effects of growth, ELG, and reserve, will vary among companies. As a result, these rates would have little meaning as an average and will result in over-and under-recoveries for the carriers whose reserve position differs from the industry reserve position.

If this option is implemented, it should be staggered over three years in conformance with the current represcription schedule, with separate rate ranges being established for LECs and the IXCs. As with the basic factors range option, rate ranges should be utilized initially only for the more stable accounts as described above, and the option should not be mandatory. For any given account, carriers should be allowed to initially choose whether to use the rate range option or a depreciation rate based on an analysis and study of life, net salvage and reserve factors. Once the initial selection has been made, however, carriers should not be allowed to change the selection option. As with the basic factors range option, if a carrier chooses to use this option, stockholders rather than ratepayers should be responsible for any depreciation reserve problems and current amortizations of reserve imbalances should be discontinued.

The CPUC agrees with the NPRM that future review of the ranges should be made and that review should be on a less frequent basis than the current review of rates. A review after five years seems sufficient. However, a review of rates would be difficult unless a comprehensive review of basic life, salvage and reserve factors for each of the applicable accounts is first made.

Two related issues regarding this simplification option on which the NPRM seeks comments are price cap treatment and accumulated depreciation imbalances. We agree with the tentative finding that the rate range option should have no effect on the endogenous treatment accorded depreciation expense changes under price cap regulation. We do not agree, however, that this option would require a reserve true-up mechanism. As stated above, the rate ranges would be based on currently prescribed rates which utilize the remaining life formula. There is little logic, therefore, in associating a reserve true-up mechanism with a remaining life rate.

IV. DEPRECIATION SCHEDULE OPTION

The depreciation schedule option offers a greater degree of depreciation expense certainty, but is not reserve-sensitive. If investments were not in accord with the FCC's established life and retirement patterns, under-and over-recoveries would occur, the extent of which would not be known until the end of the life of the given vintage. Consequently, this option represents a further deviation from the fundamental depreciation principle of matching expense to capital consumption. If this option would result in a separate schedule for each vintage of a given account, then certainly the goal of simplification would not be achieved. One average service life, retirement pattern and net salvage would be applied to a given account for all carriers, providing less flexibility than the previously discussed options. Carrier specific circumstances would be of no consequence.

Should this option be adopted, it would be logical that the development of the initial service life, retirement pattern and net salvage value for a depreciation schedule for each account be based on industry-wide averages underlying currently prescribed rates. An alternative, however, would be to perform an initial industry-wide study of these factors for each account. As with the other simplification options, we believe that the depreciation schedule option should be utilized initially only for the more stable accounts. This being the case, the service life, retirement pattern and net salvage value for these accounts should not be expected to change significantly, thus making the need for an industry-wide study to develop initial factors unnecessary. Using currently prescribed rates would be sufficient. In the event that this option is adopted, we believe implementation should be achieved over a three-year period, in line with each carrier's normal depreciation prescription.

Under this option depreciation schedules would be designed to recover 100% of investment over a selected "service life" for a given account. In actuality that service life would not necessarily relate to the period of time the equipment would be serving the public. To the extent a particular vintage were to last shorter or longer than the determined life, there would be a mismatch of expense with consumption.

As with the other options, the depreciation schedule option, if adopted, should not be mandatory. As with the previously discussed options, if a carrier chooses to use this option, stockholders rather than ratepayers should be responsible for any depreciation reserve problems and current amortizations of reserve imbalances should be discontinued.

Two related issues regarding this simplification option on which the NPRM seeks comment are price cap treatment and accumulated depreciation imbalances. Under this option the potential for a reserve imbalance is merely temporary because the depreciation schedule option ultimately would provide full recovery.

V. PRICE CAP CARRIER OPTION

It goes without saying that the treatment of depreciation expense under the price cap scheme has been controversial. The LECs argue that depreciation rates are regulated and prescribed by an outside source (regulators) and therefore should be considered exogenous for purposes of calculating the price cap index. However, the depreciation rates are merely the end result of a company's internal construction program which dictates plant additions and retirements, key factors in determining depreciation rates. The LEC's logic, carried one step farther, says if depreciation expense changes are, in fact, endogenous, then LECs should be granted unfettered freedom in setting the rates. Unfortunately, implicit in this logic is the hidden allegation that the FCC is not prescribing accurate or correct depreciation rates.

It is no doubt true that the Price Cap Carrier Option is more consistent with the concept of depreciation being considered as an endogenous expense change. Under a pure price cap scenario with no earnings regulation or oversight, the Price Cap Carrier Option would have the most merit. In that scenario there would be less incentive to manipulate depreciation expenses because there would be no danger of the company having to share or give up revenues resulting from overearnings. However, even under a pure price cap regulatory scheme there could still be a temptation to increase or decrease depreciation expense to achieve the desired level of earnings simply because this expense could be controlled more easily than other expenses. However, the company would be fully aware that short term decisions to influence earnings could have adverse effects on long term capital recovery goals, and any such decision would be theirs to live with. No longer would they be able to seek extraordinary regulatory recognition via special amortizations or other forms of relief. Accordingly, it would only be appropriate to employ this option in a regulatory environment which has no earnings oversight.

However, under the FCC's present price cap scheme, which clearly retains earnings regulation, there is a strong incentive for the company to either hold down depreciation expenses if the company is earning below its authorized return, or to increase them if the company is earning above or near the upper end of its authorized return. Accordingly, under any form of earnings regulation, there is a potential incentive to manipulate depreciation expenses in order to produce the desired level of earnings.

If this option is adopted by the FCC, and selected by a carrier, it should be made clear that further depreciation underrecovery conditions are entirely thė carrier's responsibility, and that regulatory bailouts, such as reserve deficiency amortizations funded by ratepayers, would no longer be permitted.

VI. COST OF REMOVAL AND SALVAGE

The long-standing practice of including the estimated effects of cost of removal and salvage in depreciation rates results in substantial complication of the depreciation process. Current period accounting for gross salvage and cost of removal will simplify the represcription process.

Estimating cost of removal and salvage is not easy. In general, it can be said that there is a greater degree of uncertainty about estimates of cost of removal and salvage than there is with estimates of service life and survivor curve shape. Historic cost of removal and salvage data is frequently sparse and erratic, a fact which complicates forecasts of the future. This facet of the depreciation process is the cause of much argument and controversy in the represcription process.

Current period accounting would have a number of advantages to offer compared to the existing system. First, it would eliminate the need to study cost of removal and salvage, thereby simplifying the depreciation prescription process automatically. As indicated in the NPRM, this should result in administrative savings. Second, the removal of two speculative factors from the depreciation rate setting process would guarantee more overall accuracy. Third, adoption should lead to improved utility accountability for cost of removal, since district and regional operating results would be directly impacted by these costs. Fourth, for those plant categories where net salvage has demonstrated an increasing negative trend, the effects of that trend on depreciation rates would be stabilized. Fifth, in those predominant circumstances where overall future net salvage is expected to be negative, depreciation reserve deficiencies would be reduced.

The NPRM asks for quantification of the effects of current period accounting and whether it is contrary to Generally Accepted Accounting Principles ("GAAP"). We suggest that a separate phase of this docket be initiated to thoroughly examine these issues.

VII. RECOMMENDATION AND CONCLUSION

The CPUC agrees that the current FCC depreciation prescription process is complex and can be simplified. Of the four proposed options, we believe that the Basic Factors Range Option is the most appropriate. This option maintains the most accuracy of the four by continuing to recognize an individual carrier's accumulated depreciation reserve in setting rates. This option, however, should be adopted only for the more stable plant accounts. Initial ranges should reflect the factors which underlie currently prescribed rates, and should be updated after five years. It should not be mandatory.

If any of the proposed simplification options are adopted and utilized, stockholders rather than ratepayers should be responsible for any depreciation reserve problems which subsequently develop with respect to the plant categories for which such option is chosen. Also, under any form of simplification, it is imperative to continue to maintain accurate continuing property records.

The CPUC believes the current accounting treatment afforded cost of removal and salvage should be examined in depth. There are several advantages to switching to current period account, including the possibility of decreasing carrier revenue requirements. There are other questions which need to be addressed. A second phase of this docket or a separate docket should be initiated to thoroughly examine this issue.

Respectfully submitted,

PETER ARTH, JR.
EDWARD W. O'NEILL
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By: Ellen S. LeVine
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Dated: March 9, 1993

CERTIFICATE OF SERVICE

I, Ellen S. LeVine, hereby certify that on this 9th day of March, 1993 a true and correct copy of the foregoing COMMENTS OF CALIFORNIA was mailed first class, postage prepaid to all known parties of record.

Ellen S LeVine

Ellen S. LeVine

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